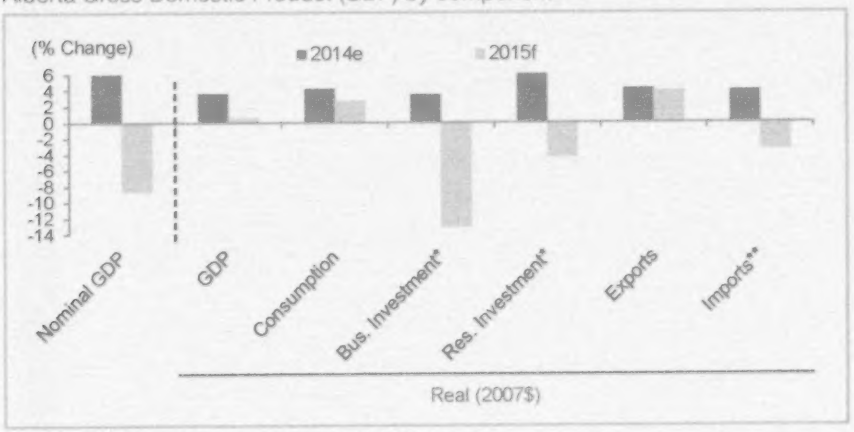
Economic Trends

Alberta economy facing headwinds

This edition of Trends is taken from the Third Quarter Fiscal Update and Economic Statement, released on February 24, 2015. The InFocus examines the current global oil price shock in historical context.

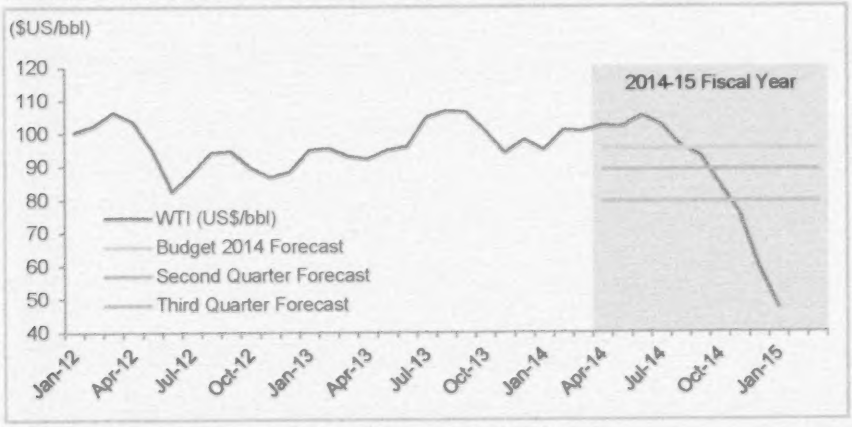
Energy market conditions have deteriorated rapidly since the *Second Quarter Update*. World oil prices, which have fallen over 50% since June 2014, will act as a brake on Alberta's fast-growing economy. The most significant impact will be on incomes earned in the province. Nominal GDP, a broad measure of income, is forecast to fall over 8% in 2015, with Government of Alberta revenue and corporate profits taking the largest hit. Lower oil prices will also weigh on the value of Alberta's exports and energy investment. Energy producers will pull back on capital spending, which will translate to lower investment activity in the province and weaker labour conditions.

Chart 1: Nominal GDP will fall but real growth remains positive
Alberta Gross Domestic Product (GDP) by component



Source: Alberta Treasury Board and Finance
* Refers to Business Investment and Residential Investment
** Imports subtract from GDP

Chart 2: Crude oil prices took a dive in 2014
WTI Price Forecast for 2014-15 Fiscal Year



Sources: Alberta Energy and Alberta Treasury Board and Finance

The impact of lower oil prices on real economic growth is expected to be less severe than on incomes. Alberta's real GDP, the volume of goods and services produced, is expected to expand in 2015, but at a much slower pace of 0.6%. This is down from the *Second Quarter* forecast of 2.8%. Strong gains in exports, supported by rising oil production and a lower dollar, are underpinning growth. Households will also contribute through population gains and consumer spending, though at a slower pace than in the last few years. These factors are expected to offset the large drag in investment (Chart 1).

The downshifting of Alberta's economy comes after a robust and prolonged expansion. In 2014, it is estimated that economic growth exceeded 3.5% for the fifth straight year. The year was characterized by record high investment, exceptional growth in exports and population, and a robust labour market. Alberta's strong economic performance in 2014, combined with continued labour market strength in recent months, will provide momentum heading into 2015.

Alberta Business Sector

Oil prices plunge

Since the *Second Quarter* update, world oil prices have fallen steeply (see pg. 14-15 for more discussion on oil price movements). As a result, the oil price forecast for 2014-15 has been downgraded, from US$88.88/bbl to US$79.24/bbl (Chart 2). Lower oil prices will weigh heavily on corporate profits, which are forecast to fall sharply in 2015. The light/heavy differential has stayed narrow and relatively stable, supported by strong heavy oil refinery demand, pipeline

expansions, and use of crude-by-rail. The 2014-15 WTI-WCS differential forecast remains around US$18/bbl.

Canadian dollar tumbles

The Canadian dollar has continued on a downward trajectory against the US dollar since *Second Quarter*. This is due to several factors, including the strengthening US dollar, weak economic growth in Canada, and falling commodity prices. The Bank of Canada's surprise move to cut interest rates put further downward pressure on the Canadian dollar. The exchange rate forecast for 2014-15 has been lowered to 88.3 US¢/Cdn$. A weaker dollar bolsters exports and resource revenue.

Lower prices hit investment

Oil and gas investment is expected to decline around 30% in 2015 due to lower oil prices. Producers will focus on more efficient projects and delay spending on exploration. Conventional investment, which is more sensitive to prices than oil sands, will be impacted the most. Weakening cost pressures will partly offset the impact of lower prices for producers. Outside the energy sector, non-residential construction activity has been strong. Elevated building permits late in 2014 provide some momentum heading into 2015.

Export volumes keep rising

Building off an exceptional year in 2014, the volume of exports and manufacturing shipments will expand in 2015. Despite the drop in investment, oil exports are forecast to grow on increasing production, as several oil sands projects under construction are expected to come on stream this year (Chart 3). Other industries, such as petrochemicals, tourism, forestry, and agriculture, should benefit from fewer cost pressures and the pickup in activity in the US. Exporters should also benefit from the lower Canadian dollar.

Household Sector

Labour market cooling

Strong job growth in December and January is providing momentum to the labour market in 2015. Employment is expected to fall well below January levels for the remainder of the year, however, due to declines in oil-related jobs. The average level of employment in 2015 is expected to be only 1% higher than in 2014, a marked slowdown from the 2.2% gain last year. The unemployment rate, which averaged 4.7% in 2014, is forecast to rise to 5.4%, while growth in weekly earnings is expected to moderate to 2.2% after five years of solid growth.

Population growth moderates

Cooling labour market conditions in Alberta and improving prospects elsewhere will temper the province's robust population growth. The province is expected to attract substantially fewer interprovincial migrants in the next couple of years as activity slows, although immigration is expected to remain resilient. Population growth for 2015 is forecast to be 2.0%, down from 2.4% at *Second Quarter*.

Housing market eases

Alberta's housing market remained tight through most of 2014. Strong demand and record low inventories in the major centers spurred double-digit gains in housing starts and put upward pressure on prices, particularly in Calgary. Starts are forecast to fall from 40,600 in 2014 to around 35,000 in 2015 on weaker demand. They will, however, be supported by builders replacing near record low inventories of new homes. Historically low interest rates will also lend support to housing. This forecast is lower than the *Second Quarter* outlook of 36,900 starts for 2015.

Consumer spending continues

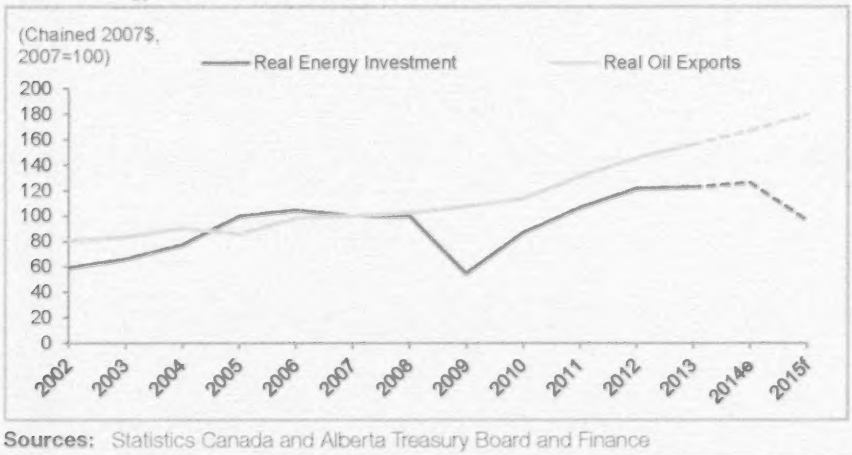
Robust wage growth in Alberta has supported retail sales that continue to outpace the rest of Canada. As the labour market cools in 2015, primary household income growth is expected to ease to 3.1%. Consumer spending is expected to grow, but at a slower pace than in the last few years. Consumer price inflation, which remained elevated for most of 2014, is expected to soften to 1.0% on lower energy prices and weaker economic activity.

External Risks

Led by a stronger US economy, global economic conditions are slowly improving, but with mixed results. Given Alberta's high reliance on trade and commodities, the outlook is subject to a number of risks:

- There is downside risk for Alberta's economy if oil prices fall further or remain exceptionally low for a prolonged period, putting additional downward pressure on economic growth.
- Falling interest rates and diverging monetary policies globally have increased market volatility. A rebound in the Canadian dollar or a drop in equity markets could weaken growth prospects.
- On the upside, an improvement in oil prices should lift economic activity and support energy investment.

Chart 3: Oil exports will grow despite lower investment
Alberta Energy Investment and Oil Exports



Sources: Statistics Canada and Alberta Treasury Board and Finance

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inFocus

The current oil price shock in historic context

The recent drop in oil prices has important implications for crude oil producers, the provincial government, and Alberta's economy. The decline will create budgetary challenges as energy royalties and income tax receipts wane.[1] This feature discusses the current imbalance in crude oil markets, and compares it with previous periods of significant market fluctuations (Chart 1).

The current slump

After peaking in June 2014 at $108/bbl, world oil prices have plummeted by over 50%. Prices have been pulled down by a combination of strong supply growth and modest global oil demand growth. Increasing production outside of OPEC, primarily from US shale oil developments, has been the main source of supply growth. The restoration of production in Libya in the past year also contributed to the supply glut. Softening demand for fuel in China, the Eurozone, and a handful of emerging markets slowed the growth of global oil consumption. This led to an imbalance between supply and demand, estimated at around 1-2 million barrels per day (Chart 2), and caused prices to decline. A decision by OPEC in November to maintain its production, rather than intervening to support prices by reducing output, reinforced the steep downward trajectory. By January 2015, WTI was trading below US$50/bbl for the first time since the Great Recession.

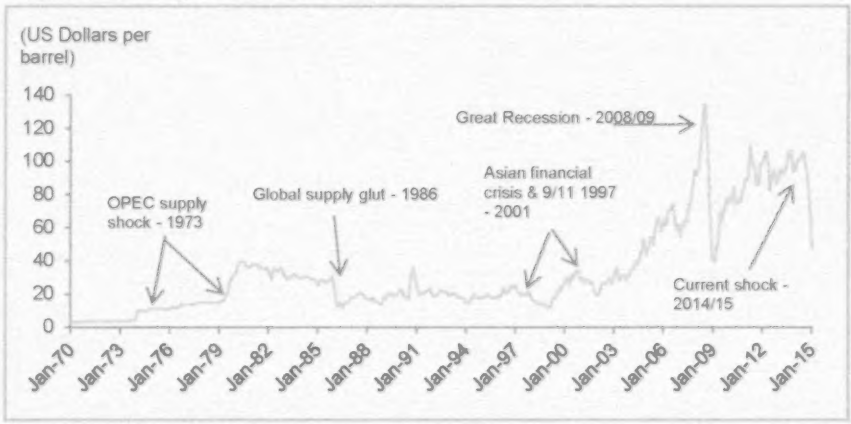
The current correction is not without precedent. The combination of oversupply and weak demand bears a resemblance to the price shock in the mid-1980s. In fact, there have been several instances when oil prices have fallen in the past several decades, sometimes rapidly (Chart 3).

Misaligned market in mid-1980s

The first major oil price decline occurred in late 1985. Over a decade of market turbulence led to shrinking demand for oil alongside growing supply. After peaking in April 1980, oil prices steadily declined until late 1985, before plunging by 52% and bottoming out in 1986.

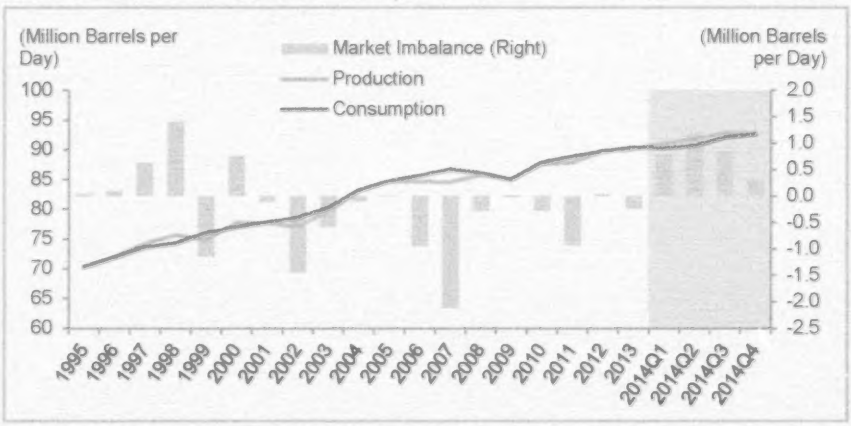
The events leading to the plunge began with the price of oil rising over ten-fold between 1973 and mid-1980. This was precipitated by OPEC's oil embargo in 1973 and continued through the end of the Iranian Revolution in 1979. Higher prices due to market instability encouraged the search for new sources of crude outside of OPEC, including offshore drilling. At the same time, OPEC's policy of restricting

Chart 1: Oil prices are volatile
Timeline of WTI Spot Prices, 1970-2015



Source: Energy Information Administration

Chart 2: Market imbalance pushed down prices
Global Crude Production and Consumption



Source: Energy Information Administration

1 For more details about the revenue challenges that the Government of Alberta government will face, see Backgrounder on Alberta's Fiscal Situation (January 15, 2015).

output resulted in waning market share for the cartel. Punitively high prices in the late 1970s slowed economic activity and incentivized improved fuel efficiency. By the early 1980s, there was a discernible surplus of crude in the market, mainly caused by shrinking demand in industrialized countries. Inflation and high interest rates also reduced the demand for crude. Saudi Arabia increased its production in hopes of recovering market share, inundating the market with even more supply. These events led to the collapse in world oil prices.

Asian financial crises and 9/11

The next occasion when oil prices declined markedly was between 1997 and 1998. During this period, prices fell by over 50% to the lowest level since 1986. The decline can be attributed to the Asian financial crises that struck in July 1997. It affected several emerging economies including Thailand, South Korea and Indonesia. The slowdown weighed on the demand for oil in the region, which had until then been a major engine of global economic growth. Continued stagnation in Japan also contributed to weaker oil demand. Prices fell as inventories rose to levels which outstripped demand.

As the turbulence stemming from the Asian financial crises subsided and global demand firmed, oil prices temporarily recovered. However, the recovery in crude markets was derailed by the September 11th attack in 2001. The attacks triggered fears of a recession and caused the price of oil to fall by 30% within three months.

Rapid rise through the 2000s

Crude oil prices commenced a meteoric rise through the mid-2000s. They increased seven-fold, reaching the market's zenith in mid-2008 at $145/bbl. Demand from emerging markets grew markedly, led by the Chinese economy, which saw annual GDP growth rates between 8% and 14% for over a decade. Other factors contributing to the run up in oil prices include a weaker US dollar and a string of geopolitical conflicts.

Collapse during the Great Recession

Beginning in mid-2008, prices began to fall, and in the following six months they imploded, losing 71%. The drop was mainly demand driven, caused by the Great Recession. In the midst of the recession, investors increasingly viewed oil prices as being too high given the amount of available supply.

Oil prices began to slide in July 2008, causing many investors to face margin calls on their long positions. As the value of other investments like stocks and derivatives declined, investors faced tightening liquidity constraints. The financial stress soon culminated in a forced sell-off as investors closed out their long positions. Oil prices bottomed out in mid-December 2008 at $30/bbl. The response was to take crude supplies off the market into storage in the short term, which supported prices as demand recovered.

Over the next four years, prices fluctuated between $80 and $105 per barrel, before the current shock.

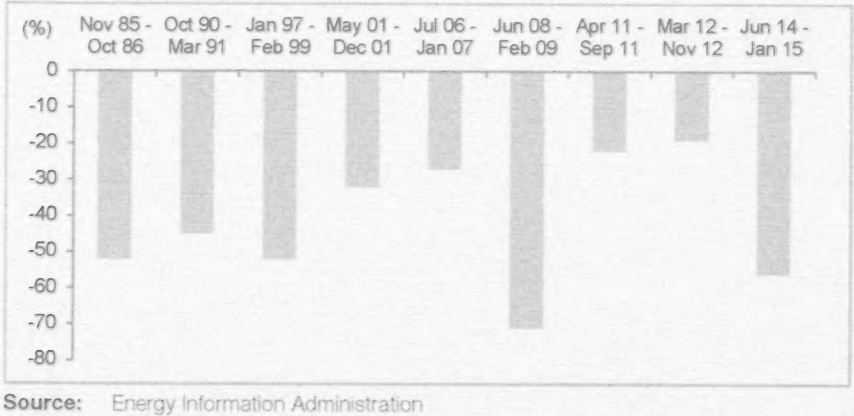
What makes this time different

Although there are some similarities between the current price correction and previous ones, there are also key differences. Marginal extraction costs are significantly higher than in the past, with few sources of cheap supply remaining. In addition, current excess supply on the market can be attributable to price levels that encouraged the extraction of higher cost crude, rather than shrinking demand.

In the 1970s and 1980s, exploration principally tapped 'light-crude' oil wells which utilized conventional extraction processes. As the demand for oil has grown, incremental increases in supply have become more expensive to produce. Much of the new supply has come from the US shale developments, Canada's oil sands, and deepwater exploration (eg, Brazil). This type of exploration is more capital intensive, with higher break-even and ongoing extraction costs. Consequently, the supply of crude that has come on-stream over the past decade requires higher oil prices to support continued production growth and profitability.

For the crude market to re-balance, some of the higher-cost supply must be withdrawn from the market as crude oil demand continues to grow. Provided that demand continues, oil prices should improve as market balance is restored.

Chart 3: The current shock in historic context
Peak-to-Trough Decline in Monthly WTI Oil Prices



Source: Energy Information Administration

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